RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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THE PICTURE: As far as I'm concerned, as far as my studies of the Dow Theory are concerned, a valid primary bear market signal was given when, on October 24, the Transportation Average confirmed the prior bearish indications of the Industrials. There are always those who cry, "The signal was late, it was too late!" But no competent Dow Theorist in history **ever waited for an actual bull or bear signal** before taking action! For instance, we bought stocks in December, 1974 before the 1975 bull market signal, and we sold our stocks in March and April of this year well ahead of the October, 1977 bear market signal. We bought and sold on many clear indications, and the final Dow Theory signal *merely confirmed what we already suspected and had acted upon.*

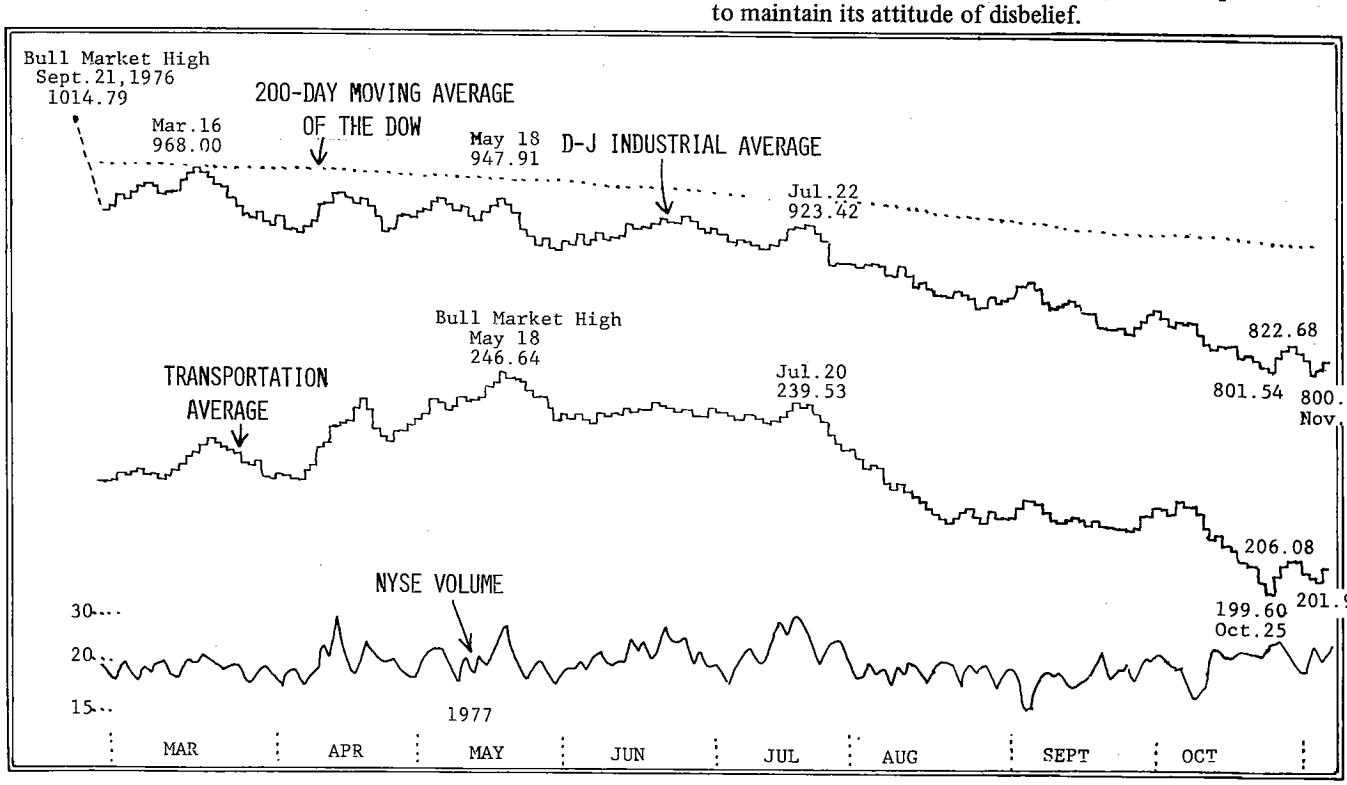
Over the past month I've been mulling over the almost unexplainable **complacency** which seems to have gripped investors and the public. I just can't figure it out. Could it be the mystifying action of the market itself? Could it be the disappointment over the death of the 1974-76 bull market? Could it be the recent eclipse of the sun or perhaps the exotic new world weather condition? Maybe it's a result of the long series of disappointments over Vietnam, inflation, Nixon, oil, deficits, and the latest in the string being President Carter. I don't know, but it's as if nothing excites the public—and nothing really discourages them.

On September 21, 1976 the D-J Industrial Average recorded its bull market peak of 1014.79. The Transports struck a peak at the same time. The two Averages then sank to September-October lows. A new rally carried to year-end 1976, but Industrials halted their advance at 1004.60 (December 31). That was the last worthwhile rally by Industrials. Despite impressive strength in Transports during 1977, the Industrial Average embarked on a steady, persistent decline. Strangely, little was said of the weakness in the senior Average. By March I grew concerned and suggested moving partly to the sidelines. By April I became so concerned that I recommended "selling all stocks." I warned repeatedly that any set of circumstances that was powerful enough (and bearish enough) to send the thirty Dow Industrials into such a relentless decline should be taken seriously. But complacency reigned.

In all fairness to the optimists, the circumstances of the bull market top were as unorthodox and exotic as anything I've even seen. "Normally" near a bull market top, the bonds and the A-D ratio and the Utility Average will peak first, followed finally by the Dow. But not so the bull market of 1974-76.

On September 21, 1976, the Industrials topped out at 1014.79. Eight months later, the D-J Transports recorded their bull peak of 246.64 (May 18, 1977). The D-J 65 Stock Average hit its high of 325.49 on December 31, 1976, simultaneously with the NYSE Composite (at 57.88). The Standard & Poor 500 touched its bull peak on September 21, 1976 at 107.83. Then we come all the way to July 22, 1977 (just four months ago) to see the D-J Utility Average top out at 118.67. The Advance-Decline Ratio for the NYSE struck its bull peak on the same day.

During 1977 many disturbing events took place both within the stock market and in the economy, but the public continued to maintain its attitude of disbelief.



(1) The nation continued to run fantastic deficits via imports of oil. Yet no one seemed to take what was happening seriously, and oil consumption continued at high levels.

(2) President Carter and his "group" showed themselves either ignorant of the economic situation, incompetent to handle it, or both. Yet the Administration continued to enjoy popular support.

(3) The dollar sagged and plunged day after day, week after week, yet no one seemed to notice or care about the frightful slide in the international value of US currency.

(4) On October 24 the D-J Transportation Average confirmed a primary bear market, yet Wall Street and Main Street remained either skeptical or complacent. Many observers claimed that the bear signal was simply a belated "Dow Theory trap" while others said that if it was indeed a bear signal, then probably the greatest portion of the market slide was over anyway. Two days after the bear signal, the market rallied sharply, as if in disbelief.

(5) Gold has now regained two-thirds of the bear market losses of 1974-76. A powerful pattern base has formed on the bullion chart (see last Letter), and the yellow metal has been acting well in all respects. Yet general skepticism seems to be the attitude towards gold. "Where's it going?" I'm asked. And my answer is, "If the dollar goes through the floor (and it acts as if it could), then gold will go through the roof." But whereas people would buy gold at the mere suggestion that it was a "good thing" back in 1973 and 1974, I find a real skepticism towards gold here in 1977. Yet the US energy problems are worse today than in 1973-74, the deficits are far worse today, and the dollar is weaker today.

(6) In the last two reports I indicated that I thought interest rates were going higher (maybe considerably higher). In view of that, I suggested that subscribers protect their bond portfolios by selling off a good percentage of bonds and putting the money into 91-day Treasury bills. Since subscribers had profits in most of the bonds they were holding, and since the bills now offer a return of over 6%, this switch did not seem to present any great hardship. Yet, from subscribers I have talked to recently, I gather that there is a "ho hum" attitude regarding the chances of interest rates going very much higher.

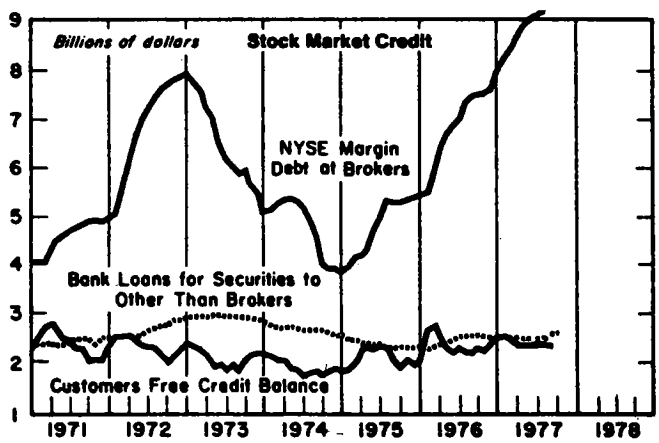
My own feeling is that the sliding dollar will have to be *defended*, and defended by much higher interest rates. Obviously, interest rates alone will not produce a strong dollar. Only elimination of the frightful US deficits will bring us a fundamentally strong dollar. But without higher interest rates, I am afraid today's "respectable" retreat from the dollar could turn into a route. In that case, much higher interest rates would come in anyway, since as foreigners dumped bonds, the supply would overcome demand, forcing bond prices down and pushing interest rates up (to some extent, I think we are seeing this now).

(7) To add fuel to the fire, a front-page article in the November 2, *Wall Street Journal* notes that corporate liquidity is beginning to run down again, thereby threatening to cut capital outlays and curb dividend increases. The last thing the economy needs at this point is a squeeze on corporate liquidity with its accompanying problems of belt tightening and possible bankruptcies.

(8) As I see it, the entire nation is now "loaned out," from individuals to corporations, from the cities to the states to the Federal Government. In this situation, any decline in the economy could set off a mad scramble for cash, in which case interest rates (especially at the short end) could spiral upwards. When a man is over his head in debt, only two things can sustain him, the continuing **confidence** of his banker, and **cash**. If confidence goes, the cash goes. Thus, in the current situation, with the nation unbelievably in debt, it is confidence (which begets cash) that is crucial. Confidence is the one item that is now holding up the nation. The fact is that the capital is used up, and we're swimming in a sea of debt so huge that it defies the imagination.

All in all, I think the thing that bothers me most at this time is the general lackadaisical attitude towards this bear market (a bear market that is now confirmed under Dow Theory). In my experience, I have found that the signals that should be taken ***most seriously*** under Dow Theory are the ones that are greeted with the ***most disbelief***. If so, this bear market could have a long way to go before it reaches the final bottom.

Speaking of disbelief, I am including this chart from a recent issue of *Barron's*, a chart showing the record high level of stock market margin. Since a goodly part of this margin build-up has to be based on money borrowed for the purchase of common stocks, I think that the chart gives mute testimony to the tenaciousness of the bull camp. Classically, if this is to be a major and extended bear market, we can expect to see this margin debt run down to at least the level which exited at the preceding bull market's beginning. That would take the margin debt down to the "under $4 billion" level of 1974.



NEAR-TERM MARKET: Turn to the page 1 chart of the D-J Averages. Here we see October 25 lows of 801.54 for Industrials, 199.60 for Transports. Next, a little rally took the two Averages to 822.68 for Industrials, 206.08 for Transports. A new decline then carried Industrials down to 800.85, but Transports did not confirm.

Now a few things interested me about the most recent lows and they are as follows: (1) The Dow never broke decisively below the 796.19 or 50% level which I have discussed so carefully, (2) we did see a little non-confirmation by Transports, (3) the last confirmed lows occurred in October, a month which I have discussed via my Fibonacci studies, (4) there has not been so much as a 5% rally in Industrials during 1977, an unprecedented occurrence. Any turn, therefore, could be the beginning of at least a 5% (40 point) rally.

Industrials and Transports recorded little peaks at 822.68 and 206.08. If those two levels are **both** bettered, we could have a

further and possibly even frenzied rally, fired up by hope and short covering. My own feeling is that we have **not** seen the real bottom of the bear market and we have probably not even seen an important secondary bottom. The reason I say that is because my various indices did not register anything like a real over-sold condition, and this makes me skeptical. The fact is that I have not had an over-sold area in all of 1977, and I ascribe this to the persistent and almost unshakeable optimism (or should I call it complacency) of 1977.

Now I am well aware that the market "can do anything." But if this rally continues, I would say that my indices would become over-bought at around Dow 850-875. Therefore, the best I see ahead would be something like the violent year-end rally of August to October, 1973, at which time the Dow spurted from 851 to 987. That rally ended with a year-end smash and then drastic new lows in 1974.

Actually, I will be somewhat disappointed if we get a substantial rally from the recent October-November lows. I will be disappointed because a *strong rally* will probably mean a top-out in late-December or early-January and a drastic decline to new lows in the first quarter. Personally, I would prefer to see the decline continue this year to a first-class, over-sold bottom.

Question: Should I buy into a persistent rally from here?

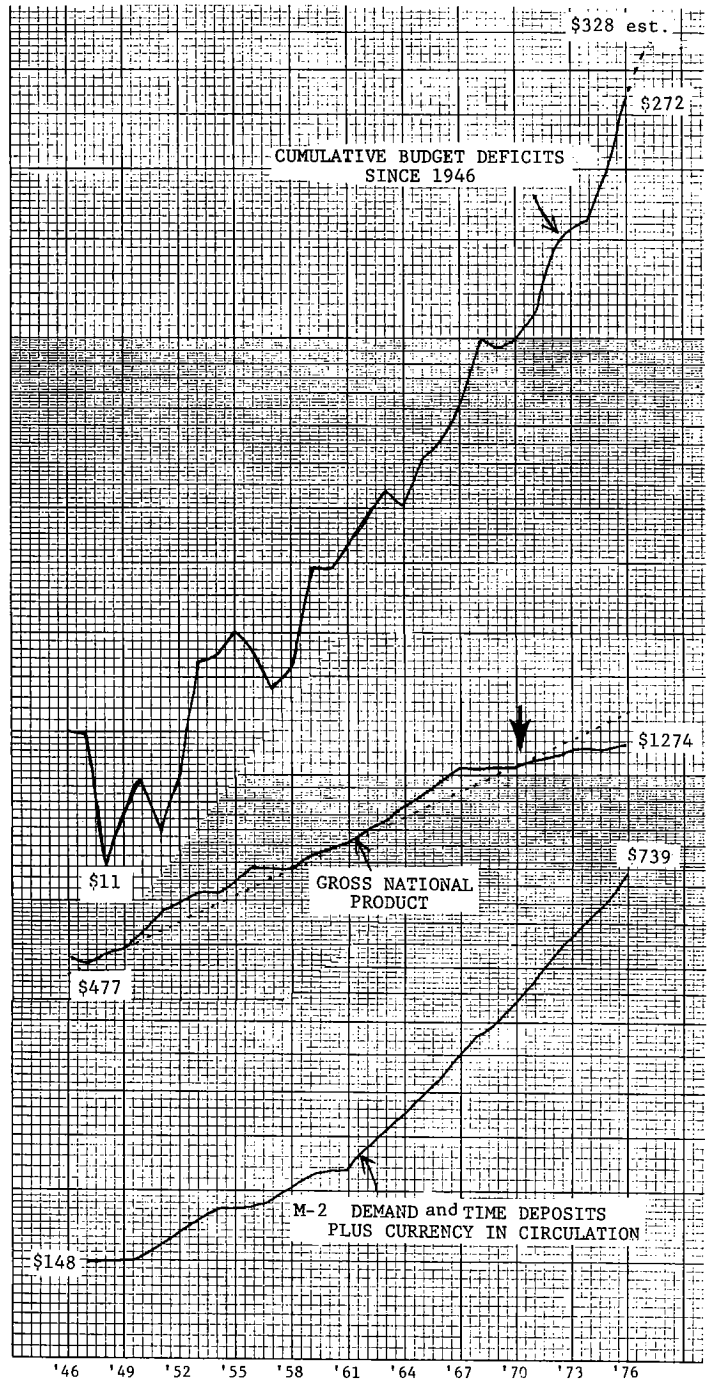
Answer: I would say "No." I don't think the great majority of my subscribers are nimble enough to be successful in-and-out traders.

Question: Suppose we get a rally that turns out to be a huge advance? Then what, Russell?

Answer: We have a number of "fail-safes" that work on either the bull side or the bear side of the market. The one I'm thinking about in particular is my study of the three moving averages of the Dow. At this juncture, the 13-week MA is a whopping 71 points below the 50-week MA, and we would need a crossing to get a major bull signal. Furthermore, the 4-week MA (short-term MA) is at 814, 29 points below the 13-week MA (intermediate-term) which is at 843. We need a crossing of the 4-week MA above the 13-week MA merely to get a "buy-alert." That would take time. So in the absence of a full over-sold bottom, I would say, "Skip any rally that may be forthcoming, or wait for the Dow's moving averages to cross."

MONEY: In the October 24 issue of *Barron's*, there appeared a remarkable article by F. D. Kalkstein entitled "Money, Money, Money." I suggest that all subscribers study this article. Mr. Kalkstein includes two tables in his article, and after examining these tabulations I decided to plot three of the statistical series. I have placed them on ratio scale chart paper, so that what we see here is movement in terms of *percentages*. In other words, a rise from 50 to 100 appears as the exact same distance as a rise from 30 to 60 or 150 to 300. That is because all of these represent rises of exactly 100%. It is also well to note that trend-lines on ratio-scaled paper are particularly significant since they show *rate* of growth.

The center index is the *US Gross National Product*, the famous and widely-watched GNP. What we see here is a steady rate of growth from 1946 through the 1960's. I have drawn a rising trendline (dotted line) which traces this growth. But in 1970 the GNP broke through the trendline. Thus we see that the great



expansion which began after World War II "ran out of steam" in 1970. Since then, as you can see on the chart, GNP has moved (in terms of percentages) almost sideways.

The lower line traces M2, which is demand and time deposits in US commercial banks plus money in circulation. It is obvious that M2 has been spiralling upward, and of course this massive increase in the money supply (from $148 billion in 1946 to $739 billion in 1976) has been a prime cause of inflation. Along with this rise in M2, we have seen a comparable rise in velocity of bank deposit turnover (not shown on the chart). These two monetary factors have been the driving force behind the great boom which began in 1946.

At the top of the chart is the cumulative US budget deficits since 1946, and these have sky-rocketed from $11.5 billion in 1946 to $272 billion in 1976 (and an estimated $328 billion in 1977). The cost of carrying these unbelievable deficits is now a major

factor in the US budget, and that cost is approaching $40 billion. This $40 billion figure can be compared with the entire US national debt in 1929, which was $16 billion!

All very interesting, but now I want to get to the point. The point is that with the explosion in M2, with the fabulous rise in the accumulated US deficits, the GNP nevertheless has failed to hold its rising trendline. Thus, I see the year 1970 as the year of "no return," the year when continuing expansion in the money supply and continuing US budget deficits failed to keep the GNP on its upward course.

What happens next? With the economy unable to get on the upward track again, the Government might opt for an even higher growth in the money supply and even bigger budget deficits (via tax cuts). But this could breed a new round of even more virulent inflation, a plunging dollar, and much higher interest rates. Such action would bring a collapse in the money markets and a massive new flight from the dollar. It is conceivable that the stock market could rush up in an explosive rally as the flight from the dollar finally spills over to equities. But such a rise would be strictly a rally in a bear market. And it would be only a very temporary phenomenon.

OR–business could continue to be sluggish, with sales sliding and unemployment heading higher. This could result in a drop in M2 as loans are repayed and as bank deposits shrink. The implications here are ominously negative, since if GNP cannot hold a rising trend with a rapidly rising M2, what will happen if M2 moves sideways or actually down?

The implication would be deflationary. Declining M2 would mean a growing shortage of cash amid sliding business and myriad corporate bankruptcies. This is really the other side of the equasion, as shown on the chart. I might also mention that if the public became wary of the banking system, there could be a major move out of bank deposits and into Treasury bills. This too would shrink M2 with a further depressing effect on the economy.

Finally, it should be remembered that the whopping budget deficits are being produced during what currently passes for "prosperity." Much of the Government's income stems from tax receipts, and any drop in corporate profits and individual income will serve to send the deficits to new highs.

I had, during most of 1977, felt that somehow we could get by this picture for another few years. With the Transports producing a primary bear signal on October 24, my heart sank. I felt that was the market's way of telling me, "Russell, stop dreaming, they can't sustain the thing any longer. From here on, it's just a matter of how it unwinds."

In my opinion, the next few years could be among the most difficult for investors since World War II. I feel that there is no long-term or over-view any longer-unless it's down. Even more unfortunate, there is no ultimate safe "island" to which we can move our investments (as, for instance, dollars or good bonds were during the depression of the 1930's).

I believe the big picture, the very big picture, is going to be the unwinding of the tower of debt which has been built up in this nation. This means deflation for the **very long pull**. In the beginning, our two best tools are going to be Treasury bills and gold for the greatest possible safety. There will be sporadic and even wild rallies in the stock market, as investors rush in for one reason or another. And we may play these rallies with part of our money. There may be a major move up in gold as frightened investors rush to the safety of the only real money. But ultimately, even gold could decline in value (during deflation). Gold could decline against dollars because in a deflation dollars buy more and more of everything, including the yellow metal.

Could the Government switch the currency, "outlaw" gold, change the rules? Every Governmentin world history has fought **to perpetuate itself**, and make no mistake about it, the Government will do anything if it thinks such moves will "save the nation." After all, who in 1946, thought the US would produce the deficits shown on the chart, all in a patriotic effort to "keep prosperity going"? Government could conceivably alter the dollar, rule that we have to turn our gold in, call a moratorium on bond interest, do anything it has to in the name of "a national emergency."

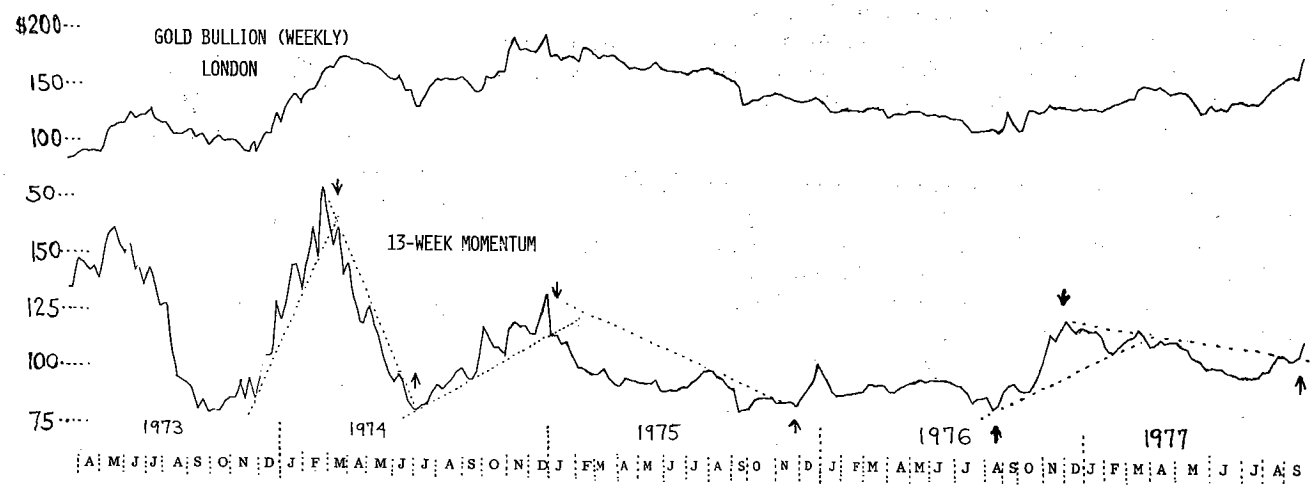
So we as investors must do the best we can to survive. Worrying won't help us, but studying and thinking will. Wringing our hands won't help us, but moving when we have to move will. I intend to guide my subscribers to the best of my ability through the long road that lies ahead.

GOLD: Although I've been recommending that my subscribers hold 5% to 10% of their assets in gold, I was **more emphatic** on this stance in the last issue. Now I'm going to be even more insistent on gold, and I'm going to recommend that subscribers up their gold positions to 15% or even 20% of assets. And when I say gold, I am talking about low-premium gold coins (such as coronas at this time) or gold bullion purchased through your broker (or gold futures, for that matter, which may be purchased through your broker).

I have been recommending gold, not gold shares, because I want the **pure gold play**. I don't want to have to worry about racial problems in S.Africa, I don't want to worry about socialism in Canada or high P/E's on Canadian gold shares, and Homestake doesn't intrigue me because it's as much a metals stocks as a gold stock, and it's selling at an unattractively high P/E ratio. In other words, I'm talking about the yellow metal–gold.

Why am I re-emphasizing gold now? First, there is the bullish pattern in gold as shown in the last Letter (point & figure chart). Next, there is gold momentum, which I illustrate on the accompanying chart (top of p.5). Remember, the market always does what it's supposed to–but never when. No one knows why things move at the exact time they do–and gold is no exception. To be brief, this chart shows the 13-week rate of change ("momentum") for gold. Gold momentum has been in a down-trend ever since November, 1976 (even though gold was building a base). A week ago gold momentum broke out to the upside. I don't know how far gold will go, but so far the momentum has not even bettered the 1976 momentum peak of 125 or the 1975 peak of 132. Gold momentum reached 180 at the early-1974 peak, and I now feel that this gold move could be as big as the 1971-74 move. I think a new gold bull market is on in full–it's as simple as that.

Now here's what nobody (or let's say very few people) know. If I asked you "How'd you like to own Swiss francs at the early-1974 price?" you'd probably jump at the chance. Why would you jump? Because the Swiss franc has been a hot item, a glamor currency. Look at my next chart (bottom of p.5). Note that the Swiss franc was about 31cents in early-1974. Gold at that time was $166 per ounce. All right, the franc is



now 45 cents or about 45% above its early-1974 price, in terms of dollars. But gold is roughly the *same price as it was in early-1974!* Now what in hell makes the Swiss franc better than gold? The irony is that the Swiss franc is highly valued **because** it has such a high level of gold backing.

Furthermore, look at it this way. If you are a Swiss investor, or a German or an Arab, and you're loaded with those hot Swiss francs (or dollars, for that matter), then you've got to be looking at gold. In terms of Swiss francs, gold is a great bargain. The fact is that if gold were to sell on a par with Swiss francs, it would have to sell 45% higher or at around 230 or better. And I think that there is an excellent chance that Gold will do just that.

Moreover, if the US stays on its inflationary path, if the money supply continues to rocket, if the rising unemployment moves our geniuses in Washington to print even more dollars, then the Swiss franc will continue to rise against the dollar, and more and more sophisticated investors will realize that gold is not only a good holding but it is a bargain. I think the whole hard currency to gold relationship is much more apparent to investors overseas than it is to Americans. And I suspect that Swiss francs and German marks and British pounds are now moving into gold. I expect American dollars to move into gold last (but they will move). And that's why I want my subscribers (who have not done so) to move now.

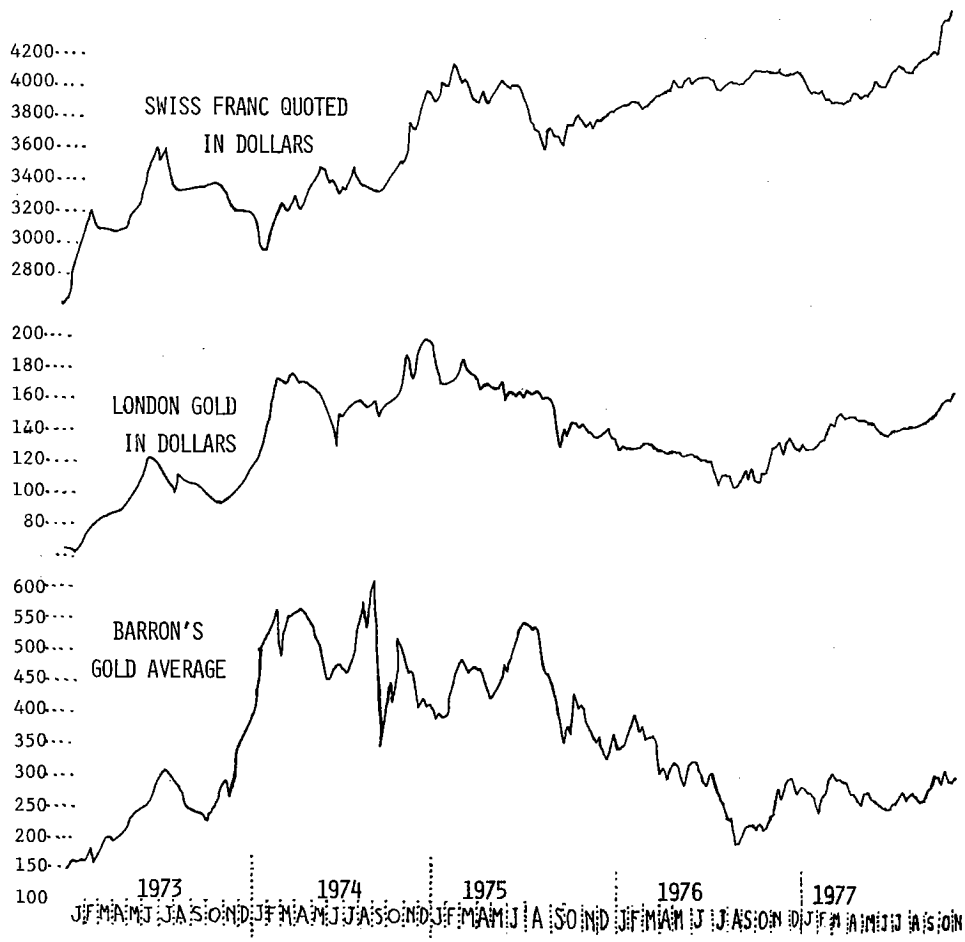
At the bottom of the chart is the *Barron's Gold Average* (stocks). This may move, too, but this Average has a long way to go to hit its 1974 high—while gold could better the old 200 high easily. That should tell us something. And it's the reason I've been saying all along—gold, not gold stocks.

Question: If I sell bonds or bills to buy gold, I lose the yield. I can't afford that.

Answer: That's why I talk percentages in gold. I'm not perfect, and I can't dream up perfect investments. Gold seems good to me, not perfect.

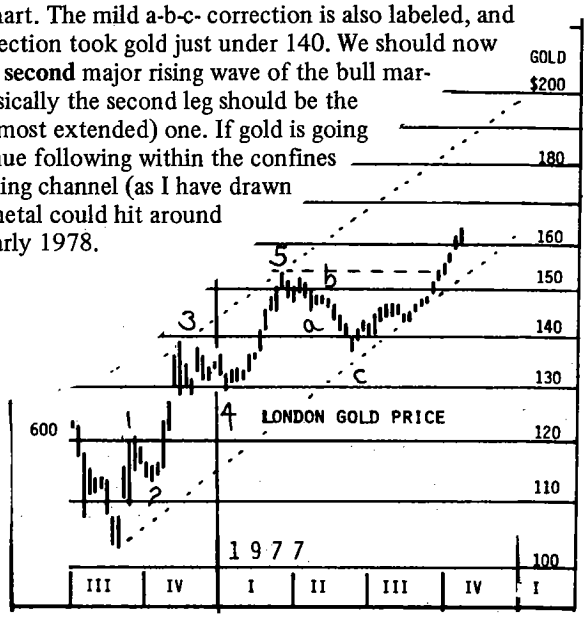
Question: Won't the IMF auctions put continuing pressure on gold?

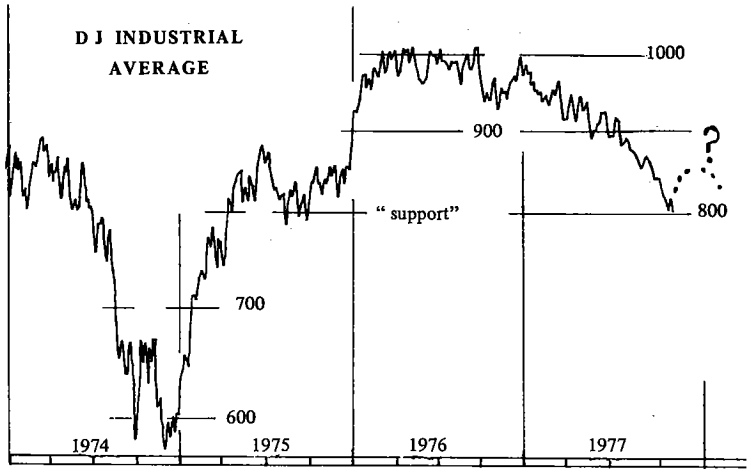
Answer: They've been putting less and less pressure on gold. And in February the "gentleman's agreement" (made in 1975) which puts Central Banks on the sidelines as far as open purchases of gold is concerned, ends. At that time Central Banks could become more aggressive buyers. Finally, the US has moved its next gold sale out to 1978. I wouldn't be surprised to see the US halt its



gold sales. And my reason is that I expect a possible "bombshell" in the coming year. That bombshell would be the Arabs asking for gold clauses in their oil contracts. Gold contracts would mean that the US would have to hang on to the big "guarantee item" behind the contracts–gold!

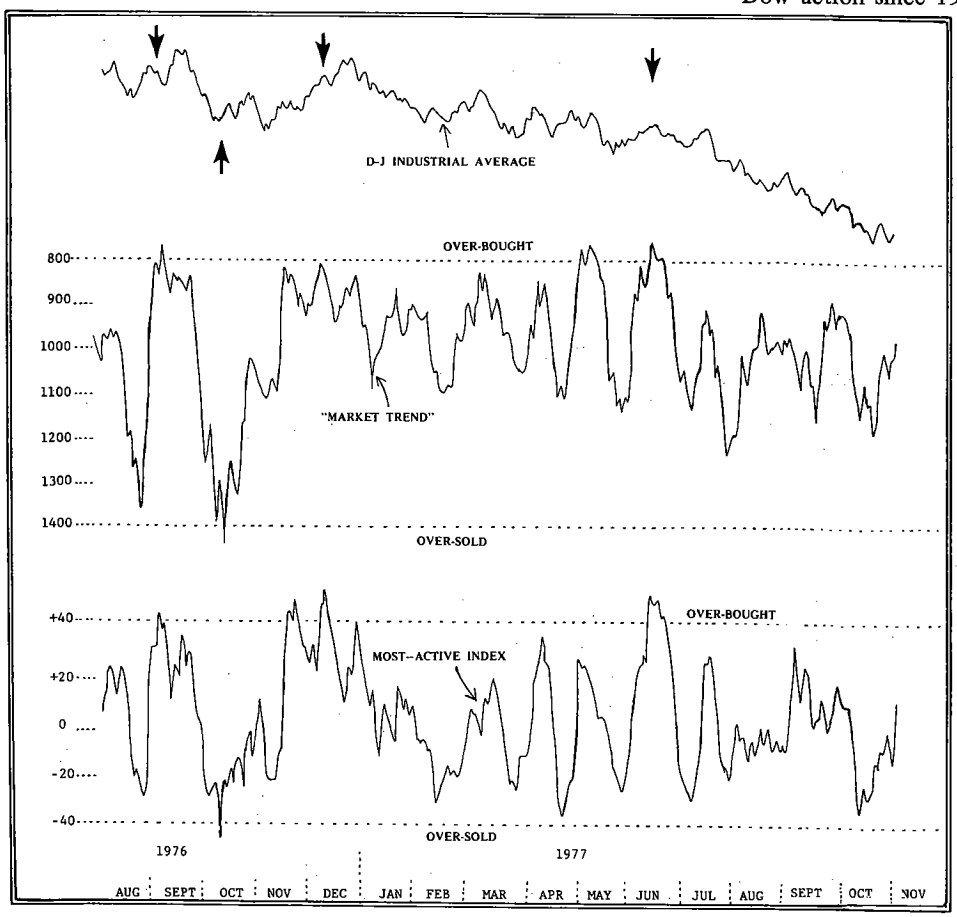
I want to close the gold section with a chart on the current gold price movement. Here is a weekly chart put out by my good friend Ian McAvity (PO Box 182, Adelaide St. Stn., Toronto, Canada M5C 2J1). As I see it, gold has completed the first leg of a probable Elliott bull market. The first leg is marked 1-2-3-4-5 on the chart. The mild a-b-c- correction is also labeled, and that correction took gold just under 140. We should now be in the **second** major rising wave of the bull market. Classically the second leg should be the longest (most extended) one. If gold is going to continue following within the confines of the rising channel (as I have drawn it), the metal could hit around 200 in early 1978.





SHORT-TERM: At the bottom-left I have up-dated my chart of the indicators which should tell us when this market is over-sold (or over-bought). The optimism continues to send both of my indicators towards the over-bought levels and away from the over-sold area. Interestingly, the odd-lot purchase to sales ratio has now dropped to its lowest rate of selling in three months. To me, this indicates that the odd-lot public believes that 800 was "the low for the market." I'm betting that the odd-lotters will be wrong. When this market finally goes over-sold, the decline should be a lu-lu.

OMINOUS: From the longer-term standpoint, the Dow has formed a potentially very bearish structure. This chart (courtesy of Trade Levels, 301 Colo. Blvd., Pasadena, CA 91101) shows the Dow action since 1974. Note that any rallying action from here would form a "right shoulder" on what now appears to be a potentially massive "head-and-shoulders" top. The "support" for the whole formation comes in at just below 800, and this accords heightened significance to the 796.19 or 50% level for the Dow.



POLICY: Gold and treasury bills are my prescription for the period ahead.

SUN & KOOKS: I suppose there are plenty of kookie spots in the nation, but honestly, where else could this happen but California–and La Jolla, at that!

> LA JOLLA (AP)—Bill Mamaya, an artist vacationing from Costa Rica, complained Wednesday that he stumbled over a naked woman lying on the sand at Black's Beach and broke his foot.
>
> The accident took place last weekend at the nation's only municipal nude beach. The "swimsuit optional" designation has been revoked by the City Council but police have delayed citing the unclothed.

NEXT MAILING: November 18th